Utah Tax Review Commission
Report of the Sales and Use Tax Working Group

January 13, 2009

I. Introduction and Background

The Utah Tax Review Commission (TRC) created the Sales and Use Tax Working Group (Working Group) to study in-depth various issues surrounding the state sales and use tax. The Working Group was originally established to draft core principles for studying sales and use tax exemptions and to organize the current sales and use tax exemptions by category.

The Working Group met several times between May 16, 2007 and January 13, 2009. As part of its study, the Working Group reviewed the criteria and principles adopted by the Utah Tax Recodification Commission and also reviewed the findings of the professional tax literature, including the recommendations of John Due, Charles E. McLure, Jr., and John L. Mikesell.

If adopted, the Working Group's recommendations would dramatically alter the state's sales and use tax system. The two major changes include: (a) excluding nearly all purchases of goods and services by businesses from the sales and use tax base ("business inputs"); and (b) broadening the sales and use tax base to include nearly all purchases by households, including purchases of services ("final consumption"). The Working Group believes that these recommendations, if implemented, present an opportunity to decrease the sales and use tax rate or provide other forms of tax relief. These recommendations will also improve Utah's business climate, eliminate tax pyramiding, and improve the economic neutrality, transparency and stability of the sales and use tax system.

Revenue from the sales and use tax is used by the Legislature fund important education, health, human service, and public safety priorities. The Working Group's recommendations provide an opportunity to modernize the sales and use tax -- making it a stable and adequate source of revenue for these critical public services.

II. Principles for a Modern Sales and Use Tax System

Preamble

The principles described below provide a guide to policymakers in the development of a modern sales and use tax system. In adopting these principles, the Working Group makes no recommendations regarding the level of tax rates or state tax revenue, recognizing that these decisions are most appropriately made by the Legislature. The Working Group also recognizes that economic development should be part of the overall discussion of developing a modern tax system.

Principles

1. Tax Final Consumption

2. Don't Tax Business Inputs

3. Don't Tax Investment and Savings

4. Consider Taxpayer and Administrator Simplicity

5. Recognize Evolving Interstate, International, and Electronic Commerce

III. Literature Review

The Need for a Modern Sales Tax

As part of its study, the Working Group reviewed the findings and recommendations of several noted sales and use tax experts. These experts argue that the state sales and use tax is hopelessly outmoded for today's economy. They argue that the tax was originally designed as an "emergency" revenue source during the Great Depression. "The tax played a significant role in both saving the states from financial collapse during the Depression," writes John L. Mikesell, "and in supporting the significant expansion in the role of state government in the last half of the 20th Century." [1]

Mikesell goes on to say that "the taxes were the product of the Depression economy and their structure has not changed dramatically since their earliest implementation. Unfortunately, many sales taxes today continue the pattern of limited coverage of services and incomplete exclusion of purchases of business inputs that characterized the earliest taxes. It is immediately apparent that the economy for which the sales taxes were initially designed bears little resemblance to the economy of today. That is true in terms of technology, types of goods and services available, range of competition among vendors, business practices, and financing to list only a few areas." [2]

So what is needed to bring the state sales and use tax into the 21st century? Charles E. McLure, Jr. recommends "a modern sales tax" with the following features:

1. "Taxation of all consumption. A modern tax would apply uniformly to all consumption: it would not exempt certain products. That way, it would not distort consumer choices of what to buy to discriminate among consumers based on their preferences for taxed and exempt products. Perhaps as important, it would not be necessary for taxpayer and tax administrators to make sometimes 'indistinct distinctions' between taxed and exempt products.

2. "Exemption of all business purchases. A modern tax would not apply to sales to other businesses. That way it would not distort decisions on the choice of business inputs or encourage vertical integration or tax-motivated 'self-production.'

3. "Exemption of investment. A modern sales tax would not be levied on investment; it

would apply only to consumption. That way it would not discourage saving and investment." [3]

While McLure laments the extent to which existing state sales and use tax systems depart from this ideal, he is less than hopeful that such a system will ever be implemented."I have no illusions that I will convince enough governors and legislators of the need to tax all consumption and exempt all sales to businesses . . ." [4]

<u>The Case for Excluding Business Purchases</u>

McLure argues that the extension of the retail sales tax to business purchases results in a flawed system. He argues that:

1. "Taxing goods bought for resale creates pyramiding (repeated taxation of the same product) and creates incentives for vertical integration, as well as inequities (discrimination against those who buy products for that are subject to multiple taxation).

2. "Taxing business purchases is likely to distort decisions on how to produce and distribute products.

3. "Taxes on business inputs also cause the perceived cost of government to be understated, because they are hidden and allow tax rates to be artificially low. Taxation limited to consumption would make the cost of government more transparent." [5]

Mikesell also contends that purchase by businesses should be excluded from the sales and use tax. "I think legislatures like the taxation of business inputs because these are 'taxes on business,' as opposed to 'taxes on individuals,' and because the eventual inclusion of the tax paid on business inputs in consumer prices makes the burden of the tax fully opaque. Despite the philosophical arguments for transparency and responsibility, both hidden taxes and taxes that appear to be paid by somebody else are politically popular. Furthermore, legislatures can selectively grant business purchase exemptions to favor certain economic activities. Objections that taxing business inputs discourages economic development, interferes with the free operation of the market, adds to the regressivity of the tax, and erodes uniformity of application of the tax have had only limited influence on legislative action. . . . Stressing the developmental significance of exempting business purchases seems the most promising approach, but legislatures still like to limit exemptions to 'good' business purchases, as if that has some real meaning." [6]

<u>The Case for Taxing All Household Consumption</u>

McLure states his case for taxing all consumption as follows:

1. "If a sales tax is to be economically neutral, horizontally equitable, and relatively simple, it should apply equally to all consumption spending.

2. "There should be no distinction between tangible products, and services, and no

distinctions based on methods of ordering or delivering products." [7]

However, rather than taxing all consumption, the sales and use tax is riddled with exemptions causing many forms of final consumption to escape the sales and use tax. Mikesell has made the following observations on sales and use tax exemptions:

> "Any exemption of household consumption is suspect tax policy. Exemptions cause higher statutory rates, make compliance and administration more expensive, cause tax burden to vary according to household preferences, and make tax yield less stable. Of course the exemptions violate the fundamental logic of the sales tax as a tax on consumption.
>
> "The intentions of reducing regressivity and of giving families a tax-free minimum can therefore more easily be provided in other parts of the revenue system -- with better targeting and less revenue lost to the government. Exemptions are politically popular, but a broad-base, low-rate sales tax with social concerns handled elsewhere in the fiscal system makes the soundest public policy." [8]

In addition to excluding or exempting all business purchases from the sales and use tax, other experts also argue that the sales and use tax should include the taxation of all goods and services consumed by households and individuals. Writing in 1988, Perry D. Quick and Michael J. McKee note that "the appropriate reform is to turn away from taxing 'goods' or 'services' as specific items, and to tax *household consumption* -- of both goods and services – instead. Such a reform could avoid the administrative difficulties involved in enumerated taxed purchases, focusing instead on who makes the purchase and taxing all such purchases." [9]

Quick and McKee argue that "state legislators should consider the introduction of a broadly based tax on the consumption of services *not as a major source of new revenues, but rather as a means to reform their entire sales tax structure*. There is no reason why such a large and growing sector of the economy should not be taxed." [10]

These authors emphasize that the purpose of extending the sales and use tax to services is not to increase state revenue but to repair the flawed design of this tax. "Correct application means, however, few new state revenues for any given nominal sales tax rate. Such a sales tax reform can even result in a net reduction in revenues if extending the sales tax on services is linked to correcting the flaw in most states' sales taxes on goods – that is, to liming the tax base for those goods sales to those related to household consumption. The payoff for the states is improved economic efficiency, fairness and – over the long run – greater political flexibility to raise new revenues through increasing sales tax rates or through restructuring and closing loopholes in other taxes." [11]

In summary, the expert writings reviewed by the Working Group unanimously agree that the retail sales tax is not well suited to today's economy. They argue that significant changes are needed if the sales and use tax is to remain a reliable revenue source for state and local governments.

IV. An Overview of Utah’s Changing Sales and Use Tax Base

Over the last 40 years, the Utah economy has shifted from an economy largely based on mining, agriculture, and manufacturing to a services and trade economy. Figure 1 shows that the share of manufacturing activity as a percent of state gross domestic product has declined from just under 20 percent in 1965 to just over 10 percent in 2005. Mining has dropped from seven percent of state gross domestic product in 1965 to three percent in 2005 and the agriculture sector's share of total state gross domestic product has also declined.

During this same period, the relative importance of services, especially financial services and construction have increased. Services made up only 10 percent of the state gross domestic product in 1965 but now comprise over 20% of state gross domestic product in 2005.

Figure 2 displays the state's sales and use tax base in relation to all economic activity as measured by state gross domestic product. Gross taxable sales as a percent of state gross domestic product have declined from 58 percent in 1981 to about 43 percent in 2005. Reasons for the decline could include changing purchasing patterns as consumers shift away from the consumption of tangible goods to increased consumption of services, increased cross-border shopping, technological changes, and new and expanded legislatively enacted exemptions to the sales and use tax. [12]

V. Outline of a Modern Sales and Use Tax System

The Working Group spent considerable time debating how the sales and use tax base should be designed. Below are the recommendation's for the definition of the sales and use tax base and a broad outline of the structure for administration and compliance.

<u>Definition of the Base</u>

A. Included in the base:

1. Retail sales and leases of tangible personal property and services to households.

2. Rental of real property by households.

3. Sales of improvements to real property to households.

B. Excluded from the base:

1. Retail sales and leases of tangible personal property and services to businesses (e.g. "business inputs.")

   “Business inputs" means:

   a. any property or service if the purchase of that property or service by the purchaser qualifies for a deduction as an ordinary and necessary trade or business expense under Section 162 of the Internal Revenue Code [13] as amended,

b. property used in the purchaser's trade or business of a character which is subject to the allowance for depreciation provided in section 167 of the Internal Revenue Code as amended,
c. property for which a deduction is allowed under Section 179 of the Internal Revenue Code as amended, or
d. property held by the taxpayer for sale.
e. Initial purchases of improvements to land by businesses
f. Rental of real property by businesses

4. Sales of raw land

5. Sales of water rights

C. Exempted from tax:

1. Isolated and occasional sales (except motor vehicles)

2. Sales by charitable organizations that are fund-raising sales

3. Certain sales by the government

4. Any exemption required by US or Utah Constitution

5. Any exemption required for the receipt of federal funds

<u>Administration and Compliance</u>

A. Purchases by a business that are excluded are purchases of goods and services that are to be predominantly (over 50%) used in the purchaser's trade or business.

B. Exemption certificates used for certain purchases

C. Purchaser applies for refund for certain purchases

VI. Summary of Revenue Effects

The Working Group requested that the Office of the Legislative Fiscal Analyst prepare an estimate of the revenue effects of the Working Group's recommendations. These estimates are presented below in Table 1.

Table 1
Estimated Revenue Effect of Working Group Recommendations
(FY 2007 - Millions of Dollars)

Category	Estimated Revenue Effects Under Alternative Treatment of Health Care Expenditures		
	If no tax is imposed on Health Care Expenditures	If tax is imposed at the point of sale	If tax is imposed on premiums and out of pocket expenditures
Rental of Housing by Households	$100	$100	$100
Business Inputs [14]	-$640	-$640	-$640
Sales of New Homes [15]	$220	$220	$220
Non-Medical Services	$330	$330	$330
Non-Medical Ins. Premiums [16]	$230	$230	$230
Health Care	$0	$290	$260
Net Revenue Effect	$240	$580	$500

As discussed later in this report, the Working Group recommends that further consideration be given to two different options regarding the tax treatment of heath care services consumed by households. Under one option, the sales and us tax would be imposed at the point of sale when the health care service is received. A second option is to impose the sales and use tax on health care insurance premiums (regardless of who pays these premiums) and any out of pocket expenditures (such as co-payments and deductibles) made by households. Purchases of health care services by households without health care insurance, or purchases of health care services not reimbursable by an insurance plan, would be subject to the sales tax at the point of sale. Table 1 presents estimated revenue effects under both alternatives.

It is important to note that these revenue effects are still being refined and are likely to change based on future study. In addition, the revenue estimates contained in Table 1 do not represent an official fiscal note of the Office of the Legislative Fiscal Analyst, but is given as an estimate of possible impact of options discussed by the Working Group. Further information, which could become available during the regular fiscal note process, could change this estimate.

IX. Issues for Further Consideration

In developing its outline of an ideal sales and use tax system, the Working Group decided that certain issues need further consideration. These include:

1. With regards to sales of motor vehicles, current law does not equitably treat the value of motor vehicle trade ins. If a purchaser trades in one motor vehicle with a dealer when purchasing another, the value of the trade in is deducted from the final sales price when determining the sales tax basis. However, when that same purchaser sells a motor vehicle as an individual, the sales tax is imposed on the full purchase price of the motor vehicle. Some options to end this inequitable treatment include:

    Option 1: Require in all transactions that the sales and use tax basis is the price of the motor vehicle before any trade ins. [17]

    Option 2: Pay the sales and use tax liability on the purchase of a motor vehicle over a certain time period with each installment payment due at the time of registration renewal.

    Option 3: Exempt sales of used motor vehicles. [18]

2. How should initial purchases by households of improvements to land be treated?

    Option 1: Impose the sales and use tax on initial purchases by households of improvements to land.

    If this option is adopted, then consider the following options for determining the sales and use tax basis:

    Option A: At time of sale, perform an appraisal of the land* only. Sales and use tax is computed as follows:

    Total sales price (less government fees) - appraised value of land* = basis for sales and use tax

    Option B: Accounting of cost of materials, labor, and profit by contractor

    Option C: Appraise improvements only using a composite building cost index, qualitative measures, or square footage.

    * Two options for valuing land: (a) pro-rata share of the raw land value; or (b) value of the developed lot

    Option 2: Do not impose the sales and use tax on the sale of completed improvements. Continue the current practice of imposing the sales and use tax on sales of building materials and examine ways to impose the sales tax on services consumed by the contractor.

The Working Group recommends that government fees associated with improvements to real property be paid by the purchaser at closing. This improves the transparency of these government fees and eliminates pyramiding.

3. How should health care expenditures by households be treated?

Option 1: Impose the sales and use tax on:

(a) all health care or medical care insurance premiums; and

(b) all payments by households to health care providers, including out-of-pocket expenses such as deductibles and co-payments. .

Option 2: Impose the sales and use tax at the point of sale when the health care service is provided.

X. Conclusion

The Working Group recognizes that there are substantial administrative and compliance issues associated with this proposal and strongly recommends that public hearings be held to solicit input from all affected parties. A broad range of input should be solicited from all affected sectors of the business community, consumers, tax practitioners, local governments, and the Utah State Tax Commission.

Endnotes

1. Mikesell, John. States of Mind: A Quality Index for State Sales Tax Structure - Measuring the States Against an Ideal Standard. 2005 STT 16-1 (Release Date: December 10, 2004) (Doc. 2004-23491).

2. Mikesell, 2004.

3. McLure, Charles E. Jr. *Bring the Sales Tax Into the Digital Age*. State Tax Today, September 18, 2000. 2000 STT 181-36. (Release Date: September 13, 2000) (Doc 2000-24042) (3 original pages) Page 2.

4. McLure, September 18, 2000. Page 3.

5. McLure, Charles E. "Rethinking State and Local Reliance on the Retail Sales Tax: Should We Fix the Sales Tax or Discard It?" Brigham Young University Law Review. 2000 BYU Law Rev. 77

6. Mikesell, 1999.

7. McLure, 2000.

8. State Tax Today, November 22, 1999. *Interview: John L. Mikesell on the Present and Future of the Sales Tax.* 1999 STT 224-21. (Release Date: November 16, 1999) (Doc 1999-37015 (5 original pages)

9. Quick, Perry D. and McKee, Michael J. "Sales Tax on Services: Revenue or Reform." National Tax Journal. Vol 41. no 3. (September 1988). pp. 395 - 409

10. Quick and McKee, 1988 p.399. Emphasis added.

11. Quick and McKee, 1988 p.395.

12. Bruce, Donald and Fox, William "E-Commerce in the Context of Declining State Sales Tax Bases." National Tax Journal. Vol. LII No. 4, Part 3.

13. The language referencing provisions of the Internal Revenue Code (IRC) as amended will be refined during the process of converting the language into draft legislation. In addition, the following provisions could be added to increase consistency with case law upholding the incorporation of federal law and subsequent amendments by reference: rulemaking authority expressly delegating the determination of which IRC provisions are incorporated; guidelines for making the determination; and provisions requiring notice of relevant IRC changes to taxpayers and the Legislature

14. In some instances, estimates may need to be adjusted to ensure that there is no double counting.

15. This includes taxing the final price to the consumer, no sales and use tax is imposed on construction materials, labor is taxable, and financing, sales commission, and profit are subject to tax.

16. The insurance premiums tax has a potential interplay with the business input exclusion that should be studied further.

17. At the request of the Working Group, the Office of Legislative Fiscal Analyst (LFA) provided an estimate of the revenue effect of this recommendation. The LFA estimates that adoption of this recommendation will result in a $725,000 reduction of sales and use tax revenue. As with all revenue estimates contained in this report this does not represent an official fiscal note of the Office of the Legislative Fiscal Analyst, but is given as an estimate of possible impact of options discussed by the Working Group. Further information, which could become available during the regular fiscal note process, could change this estimate.

18. At the request of the Working Group, the Office of Legislative Fiscal Analyst (LFA) provided an estimate of the revenue effect of this recommendation. The LFA estimates that adoption of this recommendation will result in a $121,000,000 reduction of sales and use tax revenue. As with all revenue estimates contained in this report this does not represent an official fiscal note of the Office of the Legislative Fiscal Analyst, but is given as an estimate of possible impact of options discussed by the Working Group. Further information, which could become available during the regular fiscal note process, could change this estimate.